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IN THE

Supreme Court of the United States

OCTOBER TERM, 1933. No. 76.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

FIDELITY-PHILADELPHIA TRUST COMPANY, Trustee Under the Will of William L. DuBois, deceased.

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR RESPONDENT.

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The opinion of the Board of Tax Appeals (R. 13) is reported in 25 B. T. A. 1359. The opinion of the Circuit Court of Appeals (R. 26) is reported in 63 F. (2d) 949.

SUMMARY OF ARGUMENT.

I. Respondent agrees with petitioner that the payments to the widow were income to her. One alternative of petitioner's argument is that the return of "capital" theory applied to the taxation of the widow is wrong and that she should be taxed on the payments received by her from the trustee. Both petitioner and respondent hold that the payments by the trustee to the widow were income to her and therefore were proper deductions for the trustee, and on that ground ask an affirmance of the judgment below.

II. Petitioner wrongly concludes that the theory of a return of "capital" to the widow requires the reversal of the judgment below. The other of petitioner's alternative contentions is that the adoption of the return of "capital" theory, with its exemption of the widow from tax liability on the payments received from the trustee, requires the disallowance of the payments as deductions in computing the fiduciary's tax liability. This the respondent contends is an unwarranted extension of the return of "capital" theory and is contrary to the statute and leads to an incongruous and impossible situation. Whatever aspect the payments may have from the widow's standpoint, they must necessarily be income from the trustee's standpoint. The payments by the trustee to the widow are from the standpoint of the trustee income paid to a beneficiary and are allowable deductions under the statute.

ARGUMENT.

I. Respondent agrees with petitioner that the payments to the widow were income to her.

The brief for petitioner presents alternative contentions. It asks that the judgment of the court below should be reversed, unless it be concluded that the income in question is taxable in full to the widow. In point III of his argument (brief in *Butterworth* case, No. 75, pp. 18-25), petitioner states that the original position of the Government was that these payments by a trustee to a widow were income to the widow and that the trustee should be entitled to deduct the payments so made. That position the Government felt obliged to abandon because of the decision in *Warner* v. *Walsh,* 15 F. (2d) 367 (1926) (C. C. A. 2); *United States* v. *Bolster,* 26 F. (2d) 760 (1928) (C. C. A. 1), and *Allen* v. *Brandeis,* 29 F. (2d) 363 (1928) (C. C. A. 8).

The Government still feels, however, that its original position was correct and in support of that position it cites *People* ex rel. *Kight* v. *Lynch,* 255 N. Y. 323 (1931), and *Title Guarantee Loan and Trust Co.* v. *Commissioner,* 63 F. (2d) 621 (1933) (C. C. A. 5), now pending before this Court as *Helvering* v. *Title Guarantee Loan & Trust Co.,* No. 78, present term. Petitioner in his brief cites extended passages from the opinions in those two cases and states that the reasoning is so conclusive that petitioner adopts it and presents it as his argument on the question.

Our brief in this case in the court below cited the

Kight case and quoted at length from the opinion therein. We too believe that the amounts received by a widow from a trust set up for her under the will of her husband are income to the widow even before the value of her statutory rights has been received by her. We think the reasoning in the *Kight* case and in the *Title Guarantee Loan & Trust Co.* case is unassailable. We urged the principle which they adopt upon the court below when this case was there argued.

The court below did not reject that principle in its decision of the present case. It preferred to place its decision upon a different ground, as is indicated by Judge Woolley who wrote the opinion of the court in this and in the companion case of *Butterworth* v. *Commissioner,* 63 F. (2d) 944 (1933), now in this Court as *Helvering* v. *Butterworth,* No. 75, present term. At 63 F. (2d) 946, he said:

> "It should be noted that the first question submitted to us—whether payments to the widow, after election, of income from a trust constitutes a return of capital and therefore is not taxable—is the same question submitted to and decided by the three Circuit Courts of Appeals. An altogether different question before this court—one to which the widow, now exempt, is not a party—is whether the fiduciaries of the trust in returning income may deduct what they had distributed to the widow as a beneficiary and thus avoid taxes against themselves for that amount? As the first question is not before this court, we shall, of course, not pass upon it. The

second submitted question is stated as a corollary of the first. We shall not discuss it—except casually in connection with another phrase of the case. We shall, however, assume without deciding that the way in which the Circuit Courts of Appeals decided the question before them was right. We shall also assume that those courts, not having before them the question which is before this court, did not rule on that question. It follows that the three cited decisions do not rule this case either on facts or in law and are present only because of the trouble they have made in the collection of taxes and are pertinent only as the trend of their reasoning may, logically, influence an interpretation of the provision of the Revenue Acts in respect to deductions by fiduciaries in making the tax returns now under review."

If this Court, however, wishes to affirm the judgment of the court below on the reasoning of the *Kight* case and the *Title Guarantee Loan & Trust Co.* case, we have no objection thereto.

II. Petitioner wrongly concludes that the theory of a return of "capital" to the widow requires the reversal of the judgment below.

Petitioner's alternative argument is that the return of "capital" theory adopted by three Circuit Courts of Appeal, relieving the widow from taxation as it does, must of necessity prevent the fiduciary from claiming the deduction for which the respondent contends in this case. This argument of petitioner is not founded upon a valid basis.

The return of "capital" theory is one that was adopted and applied by the three Circuit Courts of Appeal in the cases referred to in connection with the tax liability *of the widow.* We are here discussing the tax liability *of the fiduciary.* It does not follow that what is capital to the widow is capital to the trust, any more than it follows that what is income to the trust is income to the widow.

The proponents of the return of "capital" theory cannot deny the obvious fact that what the trustee collects is income. The theory, however, does assert that the same amounts, when they reach the widow, are as to her returns of capital. The theory, therefore, implicitly recognizes a mutation from income to capital. The question is: when does the mutation take place?

The change could not take place while the trustee was handling the money. The only payments that the will authorized the trustee to make to the widow were payments of income. If there was not net income, the widow got nothing under the decedent's will in this case. The trustee had no right or authority under the will to pay any capital to the widow. Therefore, from the standpoint of the trustee, what it paid to the widow was income of the estate or trust. The court below brought this out clearly where Judge Woolley said in his opinion in the *Butterworth* case (63 F. (2d) 946):

> "* * * Indubitably, the thing the trustees here received from the estate was income. With

equal certainty the thing they distributed to the widow was the same income they had received. They were without power to distribute anything else. No alteration in her status from a named beneficiary to a purchaser can change that fact. Income remains income regardless of a question whether it is taxable in a particular case. Moreover, what the widow elected to take under the will was income. That was the only thing the settlor provided for her. Failing income earned, she would take nothing. The government does not go so far as to contend that, income failing, the trustees could return her capital by extracting it from the principal of the trust."

It is obvious that the statute looks at the matter from the point of orientation of the trustee because the deduction allowed is described as "the amount of the *income of the estate or trust* for its taxable year which is to be distributed currently by the fiduciary to the beneficiary." (Italics are ours.)

However, let us follow for a moment the contention of the Government and see where it leads us. Petitioner indicates that since under the return of "capital" theory the payments received by the widow are capital to her, it must follow that they are not distributions of income from a trustee to a beneficiary. Let us explore the implications of that position. If the trustee pays capital to the widow, then the current income received by the trustee from the property in its charge must go to recoup the remaindermen for the capital that is paid out to the widow. What the

trustee eventually turns over to the remaindermen then is the balance of capital left after the payments to the widow, plus the accumulated income of the trust. They would, however, get the accumulated income less the amount of tax thereon that the trustee is to pay, and thus in effect the remaindermen would be charged with a tax on income which they received in the realm of fiction and which conferred no economic benefits upon them. They would feel the burden of a tax so arbitrary in amount and so unrelated to any economic benefit that it is unthinkable.

Moreover, if a remainderman happened to be a charity—and in the present case charities took a vested one-third interest in remainder upon the death of the granddaughter, August 26, 1924 (R. 12-13)—the deduction of a tax from the interest of a remainderman would directly contravene the further section of the statute which provides that income accumulated for charities in remainder shall be allowed to the trustee as a deduction (section 219 (b) (1)).

Let us pursue our speculation as to how a disallowance of the deduction and a consequent imposition of additional tax on the trustee would work out. We have just seen that the ultimate charging of the tax against the remaindermen creates difficulties which are insuperable. It surely is not intended that the fiduciary should bear the burden of the tax. The only alternative then is that whatever tax the fiduciary has to pay should be charged against the current payments to the widow. That, however, produces the

absurdity of charging the widow with an income tax from which, under the return of "capital" theory, she is exempt. The Government's argument requires that the tax be paid by the fiduciary on the theory that what the widow gets and what the trustee pays is capital and that payments of capital are not deductible under the statute; and yet it inevitably follows that the trustee must deduct from the payments to the widow the amount of the income tax which, by hypothesis, cannot be levied upon the "capital" payments which are made. It is a curious and incongruous result.

The respondent urges two possible avenues of escape from the dilemma. One is the avenue of escape which the Government likewise urges, namely, a total disregard of the return of "capital" theory. That we have discussed in the first point of our argument where we indicated our agreement with the Government that the sound theory applicable both to this case and to the question of taxation of the widow was the theory set forth in the *Kight* case.

The other avenue of escape from the dilemma is one that the Government rejects because it would produce no tax for it. However, it is the course which the court below adopted, and which we contend is sound. That court limited the return of "capital" theory to the situation existing when the widow was the taxpayer. It refused, however, to extend the theory in violation of the express terms of the decedent's will and in the face of a wholly incongruous result, as indicated above.

As the fiduciary looks at the situation from its point of view, it is making payments to the widow of income and the widow is a beneficiary of the trust. The fact that the transaction looked at from the standpoint of the widow makes her a purchaser, does not prevent her from being a beneficiary of the trust from the standpoint of the trustee. This, too, Judge Woolley made clear in his opinion in the *Butterworth* case (63 F. (2d) 947):

> "Construed literally and as not affected by the cited decisions of the Circuit Courts of Appeals, the provisions of the acts which allow a fiduciary a deduction for 'income' 'distributed * * * to beneficiaries,' there remains the question whether the widow (a purchaser under the cases) is a beneficiary under the will. Unless the word 'purchaser' has a legal meaning that excludes all other possible relations to the trust, we can conceive that, though acquiring her interest by purchase, she holds as a beneficiary. There is, undoubtedly, a trust. The trust provides benefits for several persons, among them the widow, should she choose to accept them. She chose. The method of her choosing (by purchase, we shall say) did not alter the status she attained by the choice. She receives benefits from the trust and, receiving benefits, she is a beneficiary and is none the less so because she may have given a valuable consideration in acquiring that status."

Following the cited portion of the opinion, Judge Woolley went on to quote the definition by the

Treasury Department of the word "beneficiary" in a closely related section of the statute where beneficiary was defined as "any person entitled to an interest in the income or the principal of a trust."

It is abundantly obvious that the plain everyday meaning of the statute would include the widow as one to whom benefits were paid by the trustee and that the payments to her were deductible as income of the estate or trust distributed by the fiduciary to a beneficiary.

The court below held that the return of "capital" theory might well be recognized and allowed with respect to the tax liability of the widow; but that, nevertheless, the fiduciary was entitled to the deductions which the respondent contends for in this case. Its reasoning is sound.

CONCLUSION.

The judgment of the Circuit Court of Appeals should be affirmed, whether this Court rejects the return of "capital" theory or whether it restricts it to determining the tax liability of the widow.

Respectfully submitted,

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